

# Briefing Book

---

## FY2006 Consensus Revenue Estimate Hearing December 6, 2004

Massachusetts Department of Revenue

# Table of Contents

---

FY04 Results.....	3
FY05 Summary.....	4
FY06 Summary.....	7
Recent Revenue Trends.....	8
The U.S. Economy.....	13
The Massachusetts Economy.....	16
Massachusetts Economic Forecast Table.....	19
FY2005 and FY2006 Tax Revenue Projections.....	20
Capital Gains Projections.....	21

## FY04 Results

---

- FY04 tax collections totaled \$15.953 billion, up \$989 million, or 6.6% from FY03.
- FY04 “baseline” tax collections (i.e., growth adjusted for the impact of tax law and administrative changes) were up \$1.046 billion, or 7.2%, compared to FY03.
- FY04 tax collections were \$724 million above the FY04 revenue estimate (\$15.230 billion), primarily due to higher than projected capital gains tax collections (which totaled about \$847 million in FY04, vs. an estimate of \$579 million), changes in stock option/bonus related incomes and mergers/severance pay, and revenues resulting from changes to the corporate and income tax laws.
- Even though FY04 tax collections exceeded estimates, the two main sources of state tax revenue -- withholding and sales tax – grew only modestly, after adjusting for the impact of tax law changes:
  - FY04 baseline withholding collections were up about 3.0%;
  - FY04 baseline sales tax collections were up about 2.2%.
- Corporate and Business collections strengthened in FY04, growing by about 15.4% baseline.

# FY05 Summary

---

- **Assumptions Underlying FY05 Consensus and October 15<sup>th</sup> Tax Revenue Estimates**
  - The FY05 **consensus estimate** adjusted for revenue initiatives (\$15.930 billion) assumed a modest economic recovery in Massachusetts, with employment growth beginning at the time of the consensus estimate, in January 2004. “Baseline” revenues were projected to grow by 3.0% in the first half of FY05 but decline by 3.5% in the second half of FY05, for full year baseline growth of minus 0.4%. The second half decline was assumed to be the result of non-recurring FY04 capital gains and bonus-related tax collections.
  - After baseline tax revenue growth of 5.5% in the first quarter of FY05 (\$100 million above the consensus benchmark forecast) the **October 15<sup>th</sup> revenue revision** (\$16.231 billion) assumed the same general pattern of economic recovery, but with baseline revenue growth of 3.2% in the second quarter, 2.2% in the third quarter, and –2.4% in the fourth quarter of FY05, for annual growth of +1.8%. The October 15<sup>th</sup> estimate assumes a decline of 15% in tax year 2004 capital gains realizations, and that \$30 million in FY04 bonus-related tax revenue will not recur in FY05.

# FY05 Summary

---

- **FY05 Results Through November 2004**

- Total tax collections of \$6.236 billion, up \$316 million, or 5.3%, compared to the same period in FY04, \$38 million above the November year-to-date benchmark set out in the October 15th revised revenue estimate.
- YTD baseline growth rate of +5.1%, primarily due to higher income and sales tax collections.
- Withholding performance is consistent with no growth in employment compared to the same period in FY04, and average wage growth of 3%-4%.
- Corporate and business tax collections have weakened since the end of FY04, but are above forecast due to lower refunds in November. Corporate collections are often volatile in the first half of the fiscal year.

# FY05 Summary

---

- **Forecast for Remainder of Fiscal Year 2005 According to Economy.com, Global Insight and the New England Economic Partnership**
  - According to vendor forecasts, job growth will accelerate modestly in the second half of FY05; as compared to the last two quarters of FY04, employment will be up 1.4% to 1.7%, and wages and salaries will rise by 3.7% to 4.6%. This implies average wage growth of 2.0% to 3.2% as compared to the second half of FY04.
  - Economy.com forecasts that tax year 2004 capital gains realizations (which determine FY05 capital gains tax collections) will be about 10% higher than they were in tax year 2003.
  - October 15<sup>th</sup> estimate subtracted \$68 million for the value of the FY04 surplus that was due to unexplained refunds, pending analysis of tax year 2003 tax returns filed on extension. Now that those returns have been analyzed, it appears that the FY04 decline in refunds was not a one-time event, so this downward adjustment has been removed.
  - Using economic projections from Global Insight, Economy.com, and the New England Economic Partnership (NEEP), total FY05 tax revenue is estimated to be \$16.512 billion to \$16.593 billion, \$281 million to \$362 million above the October 15th FY05 estimate.

# FY06 Summary

---

- **Fiscal Year 2006 (According to Economic Forecasters)**
  - Economic forecasters assume that national economic recovery will gather strength over the next 18 months. Forecasters assume that the Massachusetts economy will recover as well, but not as strongly as in the U.S. as a whole. Specifically, under these forecasters' assumptions:
    - Massachusetts employment will grow 1.1% to 1.5% over FY05;
    - Massachusetts wages and salaries will grow 4.8% to 5.0% over FY05, implying average wage growth of 3.4% to 3.7%;
    - Massachusetts personal income will grow 3.6% to 4.4% over FY05;
    - Nationally, corporate profits will grow 12.8% to 13.6% over FY05.
  - Using growth assumptions from Global Insight, Economy.com, and the New England Economic Partnership (NEEP), FY06 tax revenue is projected to be \$17.341 billion to \$17.464 billion, reflecting baseline growth of 5.0% to 5.3% over FY05.

## Recent Revenue Trends

---

- **Two Measures of Tax Revenue Growth:**
  - Actual growth - growth in actual collections over two periods.
  - Baseline growth - growth had there been no tax law or administrative changes that affected tax collections. Baseline growth also adjusts for fluctuations in the timing of tax collections. Baseline growth is a better measure of the change in the underlying tax base and the economy.

### FY05 Revenue Performance Through November 2004

	<u>Actual Growth</u>	<u>Baseline Growth</u>
Total Taxes	5.3%	5.1%
Income Total	7.1%	5.6%
Income Withholding	4.1%	4.1%
Income Estimated Payments	21.1%	7.6%
Sales	3.7%	4.4%
Corporate & Business	-5.9%	2.7%
All Other	7.1%	5.3%



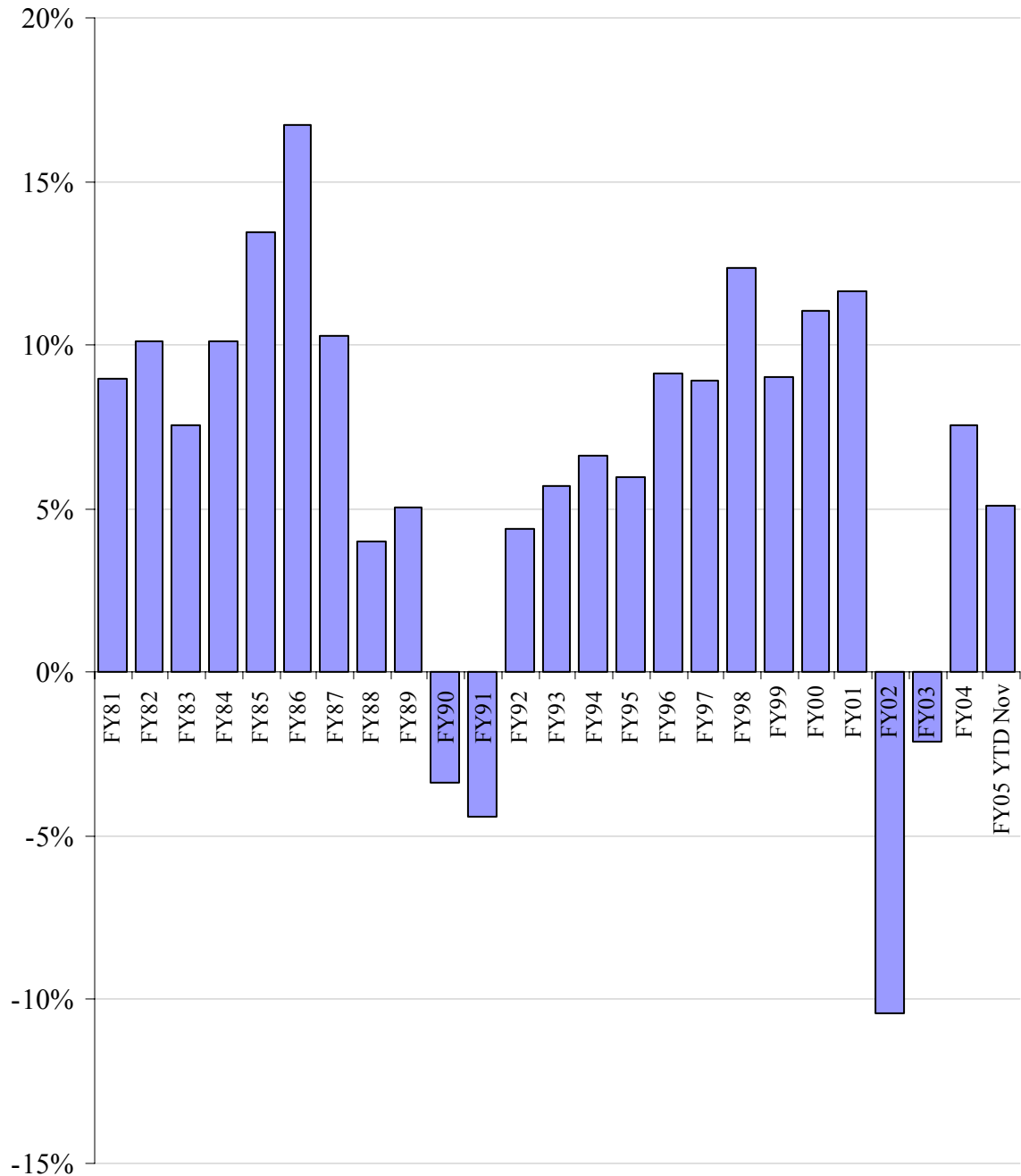
# Recent Revenue Trends

---

- **Withholding**
  - Withholding up modestly, due almost entirely to growth in average wages – Massachusetts employment is virtually even with year ago levels.
  - Bonus season is just starting, and will affect withholding collections from December 2004 through March 2005.
- **Income Tax Estimated Payments**
  - Taxpayers have increased their estimated payments, presumably in response to higher capital gains and growth in unincorporated business income.
- **Sales Tax**
  - Sales tax collections are up 4.4% baseline, continuing a modest recovery that began in the second quarter of calendar year 2004.
- **Corporate and Business Excise**
  - After a strong performance in FY04, corporate and business taxes have been erratic in FY05.

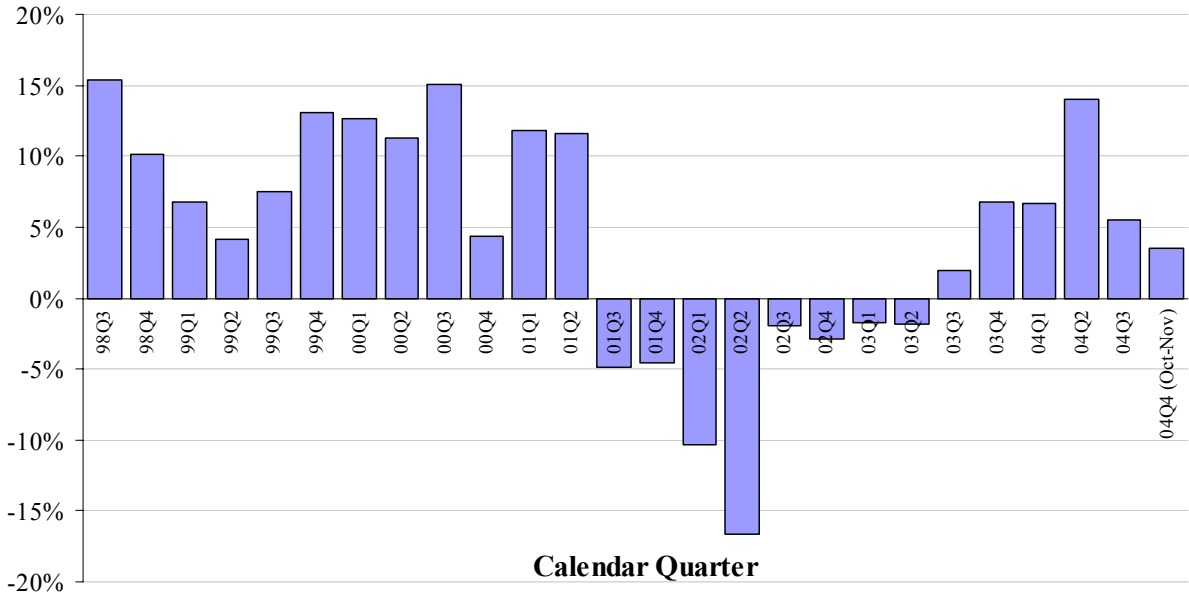
# Recent Revenue Trends

Annual Baseline Tax Revenue Growth, FY1981-FY2005

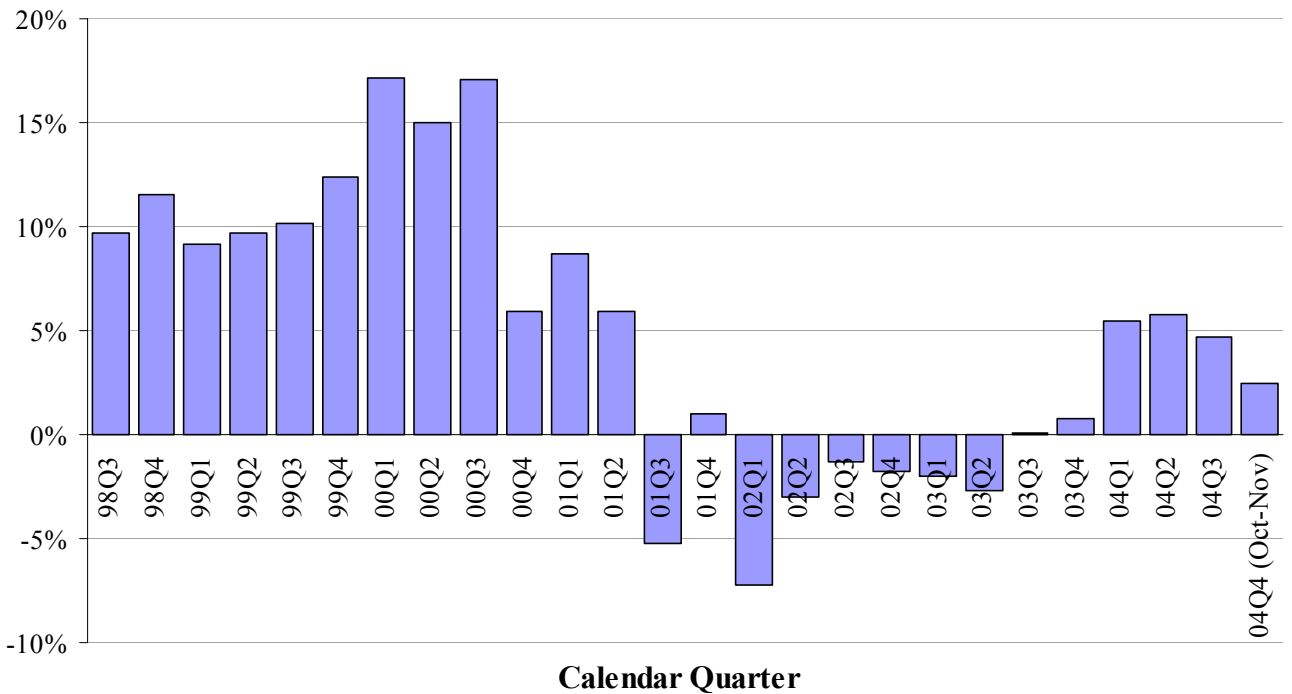


# Recent Revenue Trends

**Quarterly Baseline Total Tax Growth, FY99-FY05, % Change Prior Year**

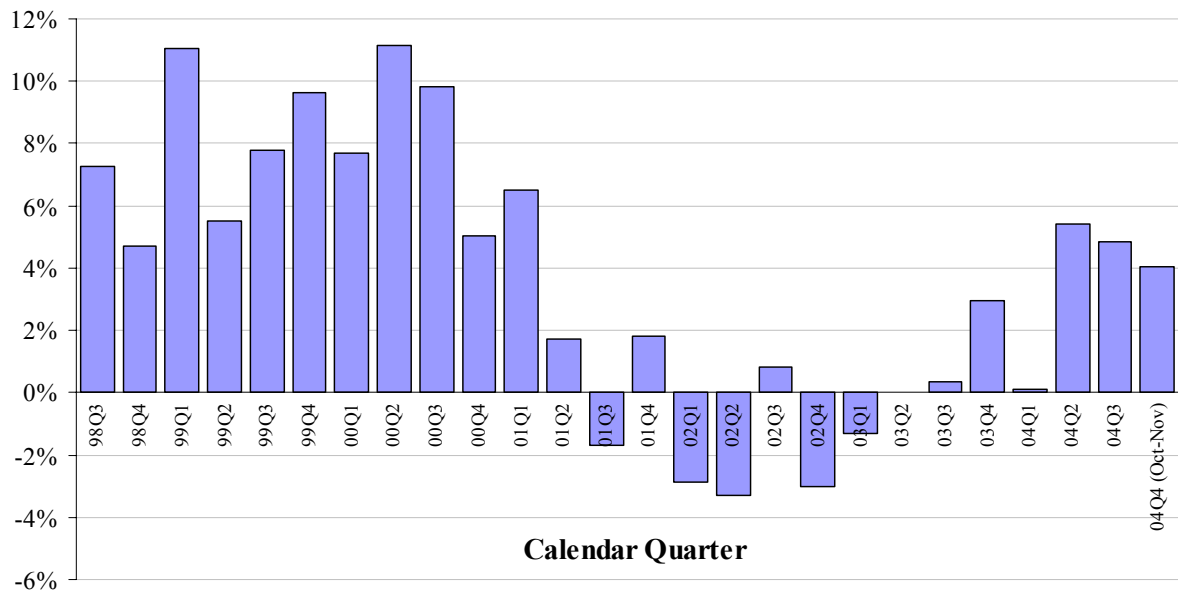


**Quarterly Baseline Withholding Growth, FY99-FY05, % Change Prior Year**

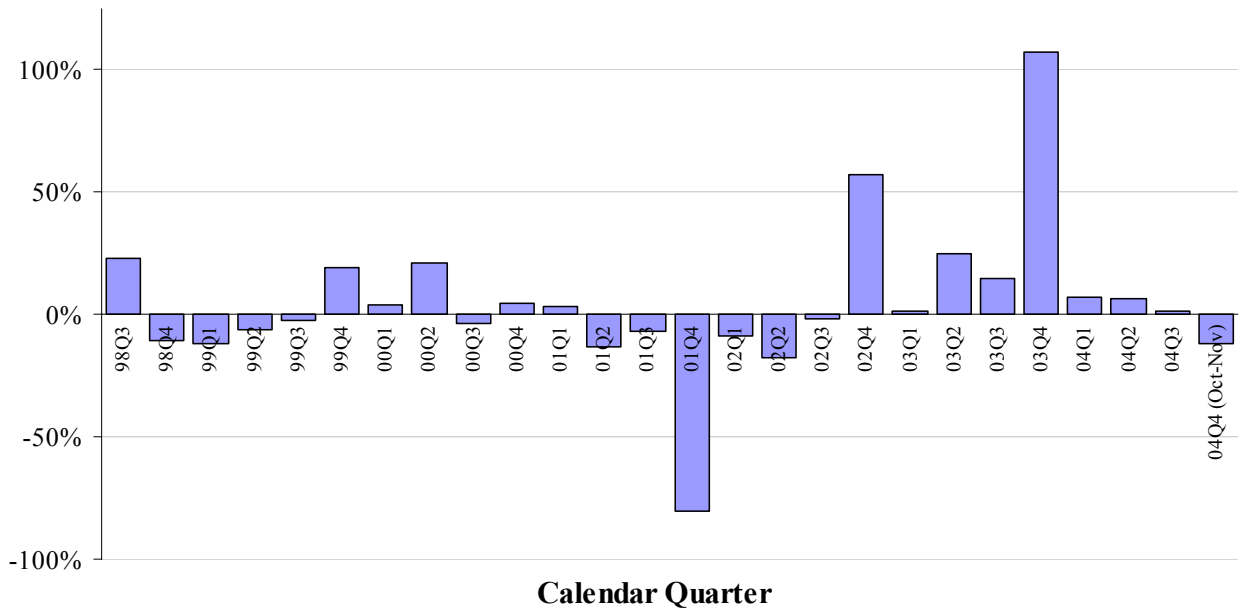


# Recent Revenue Trends

Quarterly Baseline Sales Tax Growth, FY99-FY05, % Change Prior Year



Quarterly Baseline Corporate Tax Growth, FY99-FY05, % Change Prior Year



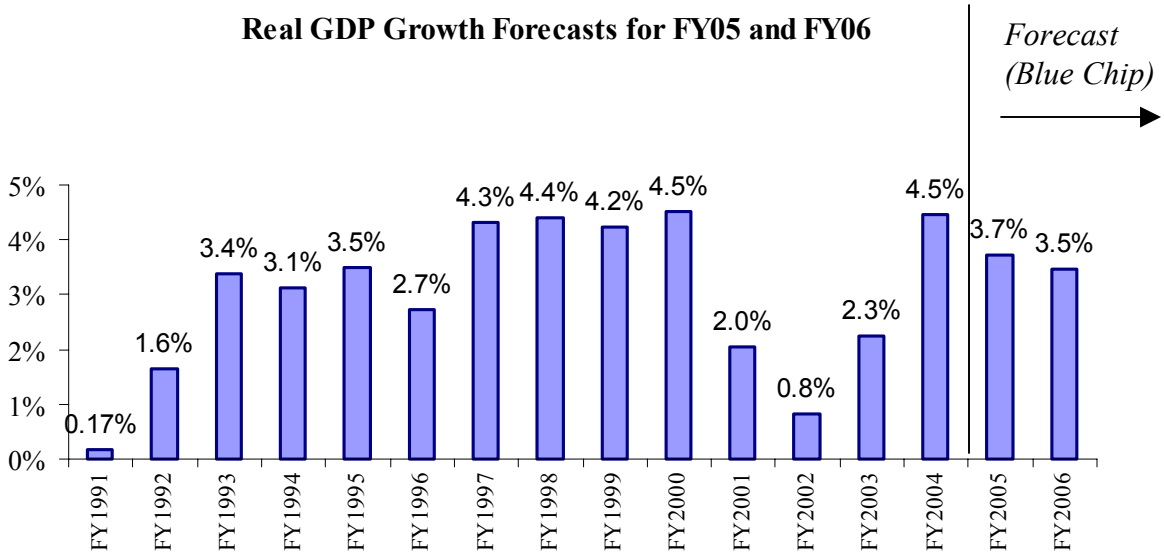
# The U.S. Economy

---

- DOR utilizes national and Massachusetts state forecasts from Global Insight (formerly DRI-WEFA), Economy.com, the New England Economic Partnership (NEEP), and the Blue Chip Economic Indicators.
- The national recession ended in November 2001, and GDP growth has accelerated since then, with 2004 third quarter real GDP growing at an annualized rate of +3.9%.
- However, payroll job growth has been relatively weak until recently. Through November, payroll jobs were 432,000 below their peak in March 2001.
- The stock market, as measured by the Wilshire 5000 total market index, is up 9% since December 31, 2003, and 35% since December 31, 2002.
- The Federal Reserve has continued to increase its target short-term interest rate, which is still low by historical standards (2%-current vs. 6.5%-May 2000), and the Fed believes that underlying inflation is still relatively low stimulating housing purchases and mortgage refinancing. This helped current economic recovery, and was a significant source of support to the Massachusetts economy.
- Most economic forecasters expect moderate growth in Gross Domestic Product (GDP) in FY05 and FY06, with the Blue Chip consensus forecast calling for real GDP growth of 3.7% for FY05 and 3.5% for FY06 after growing at a 4.5% rate in FY04.

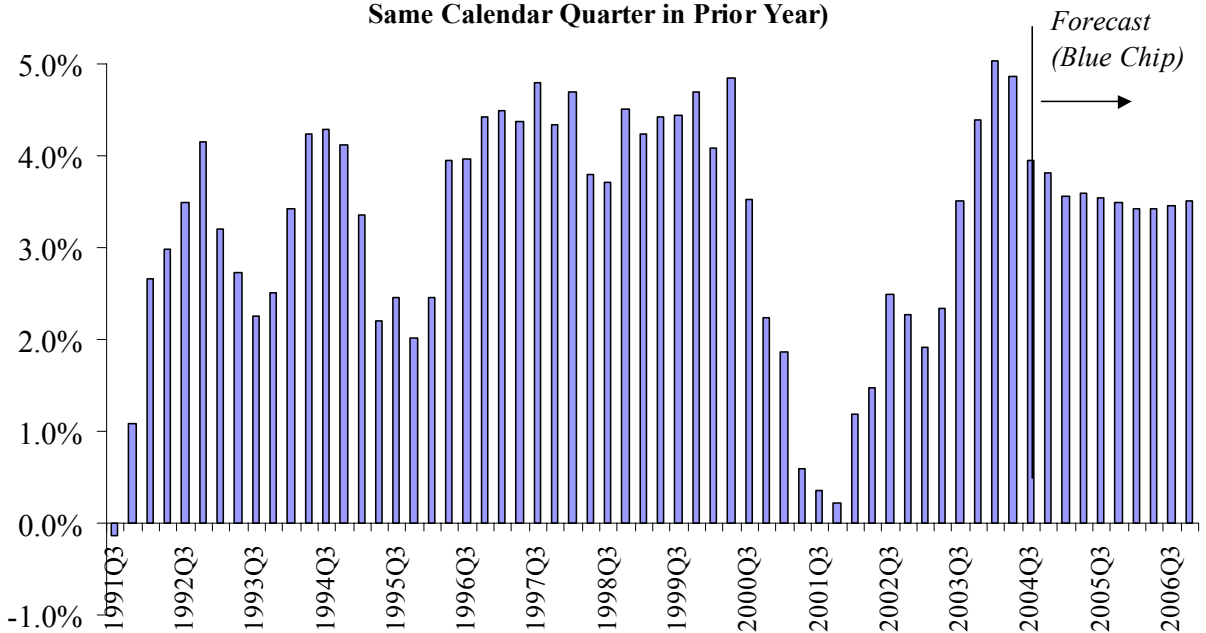
# The U.S. Economy

**Real GDP Growth Forecasts for FY05 and FY06**



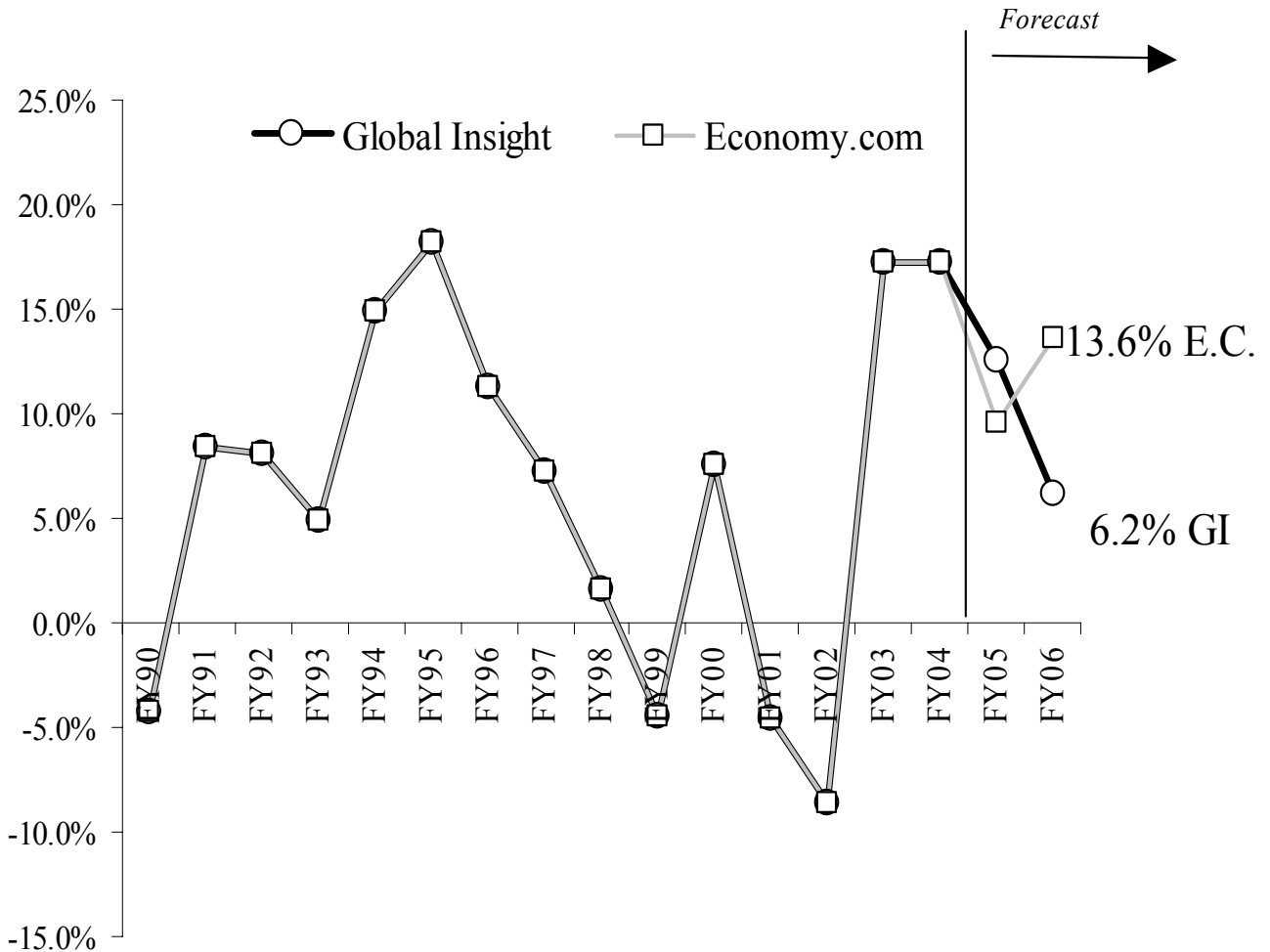
**Consensus Forecast is for Moderate Economic Growth Through FY05 and FY06**

(October 10, 2004 Blue Chip Consensus Real GDP Forecasts, % Change from Same Calendar Quarter in Prior Year)



# The U.S. Economy

## U.S. Corporate Profits Will Continue to Grow in FY05 and FY06



# The Massachusetts Economy

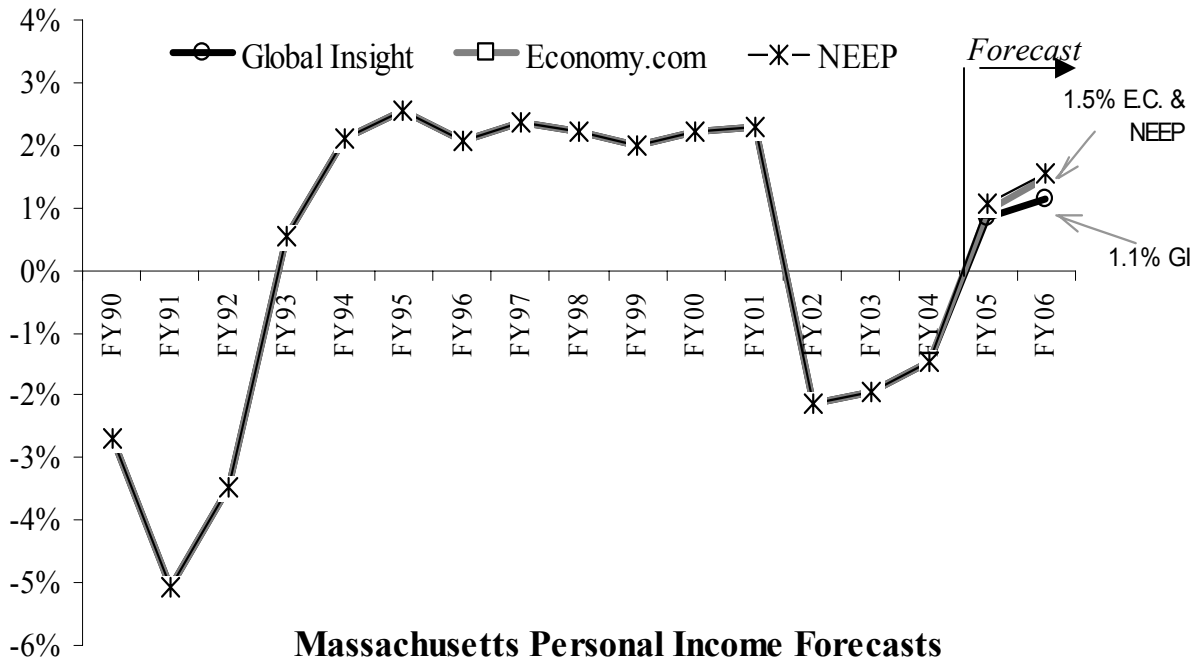
---

- The Massachusetts economy has not recovered as rapidly as the national economy. According to the “Massachusetts Benchmarks”, the state’s economy started to emerge from the recession in March 2003 (as measured by the gross state product, or GSP) though at a growth rate slower than that of the nation.
- Even though the Massachusetts economy emerged from recession in March 2003, the contraction in Massachusetts employment continued through February 2004. While the Massachusetts economy has added 26,000 jobs in the last eight months, since the beginning of the recession, the state has lost 184,000 payroll jobs, 5.5% of total employment.
- Though employment began to grow in the second quarter of 2004, on a year-over-year basis Massachusetts employment was virtually flat between October 2003 and October 2004.
- The Massachusetts unemployment rate in October 2004 was 4.6%, down from 5.9% in December 2003, but still up from a low of 2.5% in March 2000.
- Economic forecasters predict moderate growth in the Massachusetts economy in FY05 and FY06 (see charts starting on page 17).

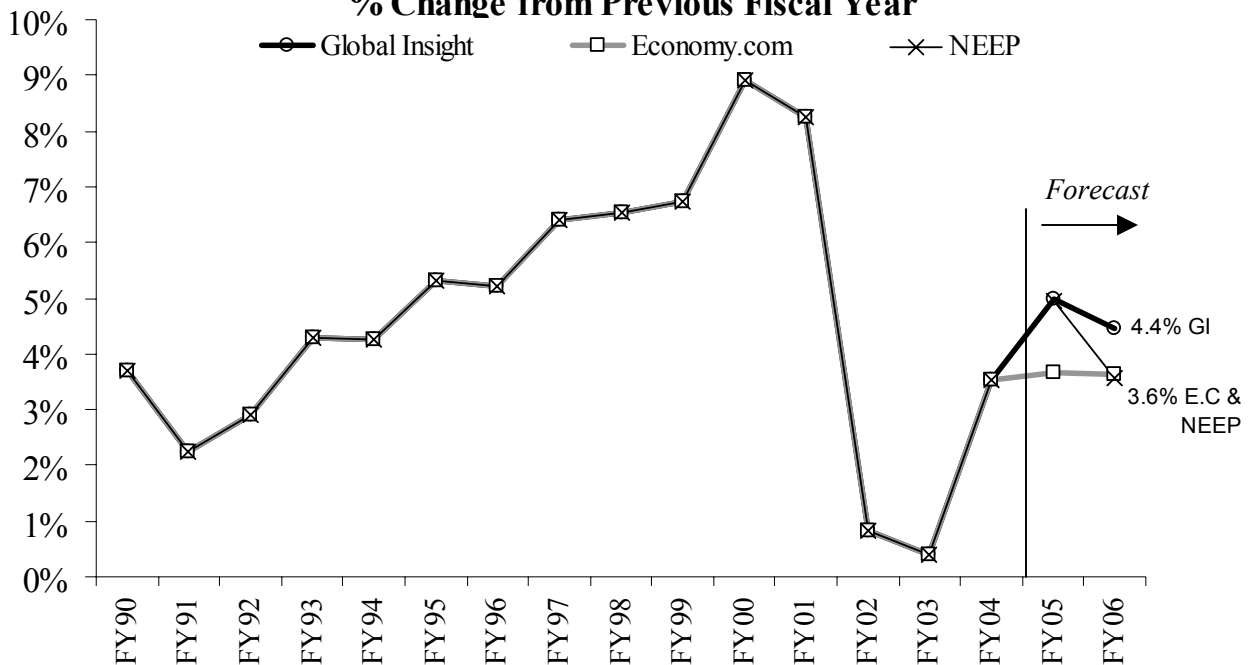


# The Massachusetts Economy

## Massachusetts Employment Forecasts % Change from Previous Fiscal Year

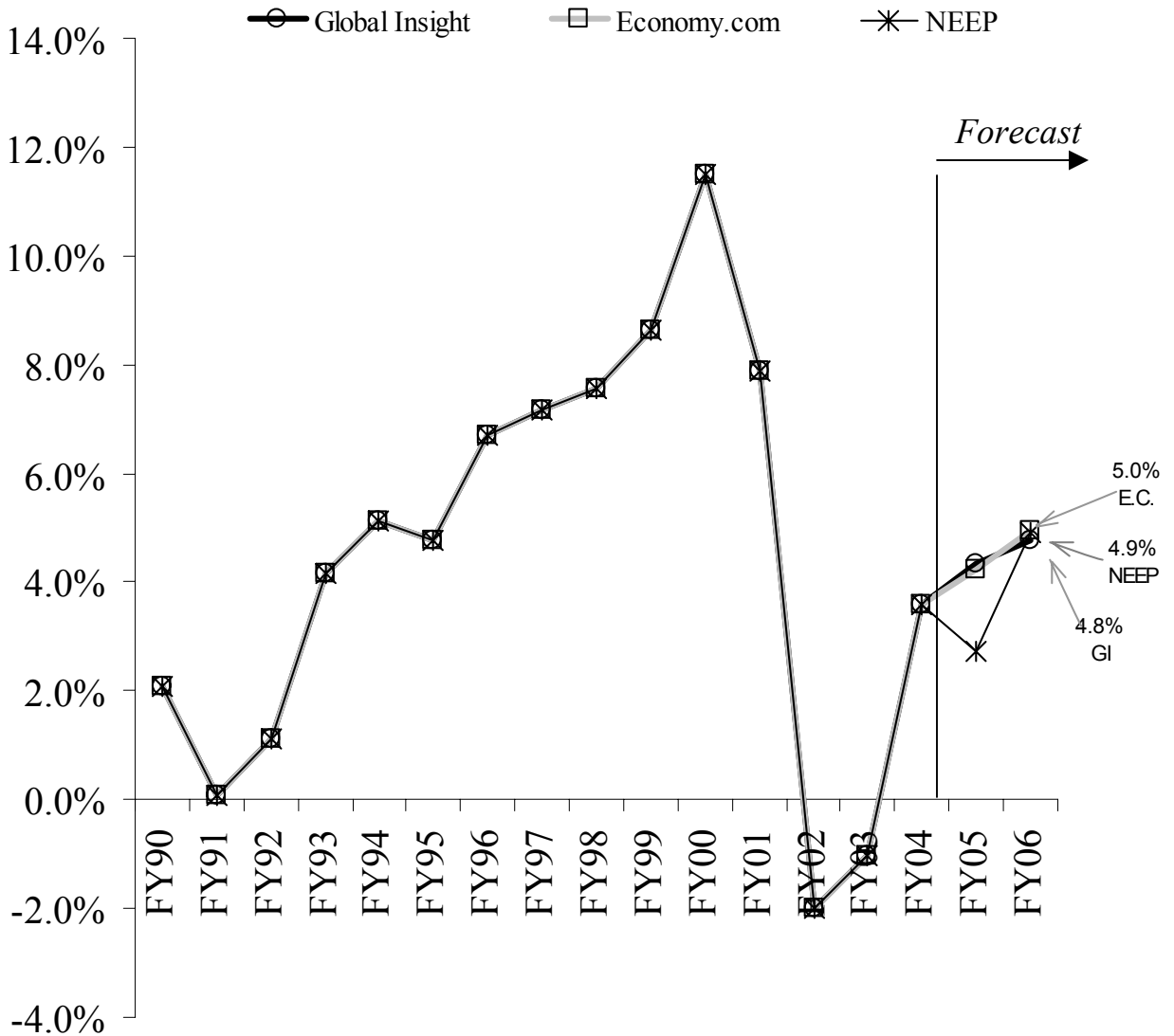


## Massachusetts Personal Income Forecasts % Change from Previous Fiscal Year



# The Massachusetts Economy

## Massachusetts Wages & Salaries Forecasts % Change from Previous Fiscal Year



# Massachusetts Economic Forecast Table

(Percent Change)

	FY 2002	FY 2003	FY 2004	FY2005			FY 2006
				<i>First Two Quarters</i>	<i>Last Two Quarters</i>	<b>Full FY</b>	
<b><u>US (Global Insight)</u></b>							
Real GDP	0.8%	2.3%	4.4%	3.8%	3.4%	3.6%	3.0%
Corporate Profits	-8.6%	17.3%	17.2%	6.8%	18.1%	12.6%	6.2%
S&P500	-16.6%	-19.7%	20.5%	9.5%	4.1%	6.7%	4.6%
Unemployment Rate	5.5%	5.9%	5.8%	5.4%	5.3%	5.4%	5.4%
<b><u>US (Economy.com)</u></b>							
Real GDP	0.8%	2.3%	4.4%	3.9%	3.6%	3.8%	3.1%
Corporate Profits	-8.6%	17.3%	17.2%	4.1%	14.7%	9.5%	13.6%
SP500	-16.6%	-19.7%	20.5%	8.9%	3.8%	6.2%	9.2%
Unemployment Rate	5.5%	5.9%	5.8%	5.4%	5.5%	5.4%	5.4%
<b><u>Massachusetts (Global Insight)</u></b>							
Real GSP	-0.5%	2.2%	4.6%	4.3%	3.6%	3.9%	3.4%
Wages & Salaries	-2.0%	-1.0%	3.6%	4.1%	4.6%	4.3%	4.8%
Personal Income	0.8%	0.4%	3.5%	5.2%	4.8%	5.0%	4.4%
Employment	-2.1%	-1.9%	-1.5%	0.3%	1.4%	0.8%	1.1%
Unemployment Rate	4.7%	5.6%	5.5%	5.1%	5.1%	5.1%	5.1%
Housing Starts	-2.7%	-5.5%	23.7%	-29.0%	-17.4%	-23.7%	-6.6%
<b><u>Massachusetts (Economy.com)</u></b>							
GSP (real)	-1.3%	1.3%	2.0%	3.3%	3.9%	3.6%	3.3%
Wages & Salaries	-2.0%	-1.0%	3.6%	4.0%	4.4%	4.2%	5.0%
Personal Income	0.8%	0.4%	3.5%	4.0%	3.3%	3.7%	3.6%
Employment	-2.1%	-1.9%	-1.5%	0.3%	1.6%	0.9%	1.5%
Retail Sales	2.0%	2.4%	3.4%	5.8%	3.2%	4.5%	3.5%
Unemployment Rate	4.7%	5.6%	5.5%	5.0%	5.0%	5.0%	4.9%
Housing Permits	2.8%	-2.9%	25.8%	-1.9%	-8.9%	-5.3%	-18.0%
Home Sales	3.3%	-0.1%	15.3%	3.2%	-11.8%	-4.4%	-17.2%
<b><u>Massachusetts (NEEP)</u></b>							
GSP (real)	-1.3%	1.3%	2.0%	2.1%	2.1%	2.1%	3.2%
Wages & Salaries	-2.0%	-1.0%	3.6%	2.8%	3.7%	3.3%	4.9%
Personal Income	0.8%	0.4%	3.5%	4.0%	3.4%	3.7%	3.6%
Employment	-2.1%	-1.9%	-1.5%	0.4%	1.7%	1.0%	1.5%
Retail Sales	2.0%	2.4%	3.4%	3.9%	3.9%	3.9%	4.5%
Unemployment Rate	4.7%	5.6%	5.5%	5.1%	5.2%	5.1%	5.1%

*Note: Growth is from previous year or the same quarter of previous year*

# FY05 & FY06 Tax Revenue Projections

---

**FY05 and FY06 Tax Revenue Projections Based on Assumptions of  
Economy.com, Global Insight, and the New England Economic Partnership  
( in \$ Billions)**

	<b><u>FY05 Projections</u></b>	<b><u>% Growth Actual from FY04</u></b>	<b><u>% Growth Baseline from FY04</u></b>	<b><u>FY06 Projections</u></b>	<b><u>% Growth Actual from FY05</u></b>	<b><u>% Growth Baseline from FY05</u></b>
<b>NEEP</b>	<b>\$16.512</b>	3.5%	<b>3.0%</b>	<b>\$17.341</b>	5.0%	<b>5.1%</b>
<b>Economy.com</b>	<b>\$16.533</b>	3.6%	<b>3.2%</b>	<b>\$17.352</b>	5.0%	<b>5.0%</b>
<b>Global Insight</b>	<b>\$16.593</b>	4.0%	<b>3.5%</b>	<b>\$17.464</b>	5.2%	<b>5.3%</b>

# Capital Gains Projections

---

- Preliminary income tax return data for 2003 indicate that 2003 capital gains realizations were \$13.5 billion, versus \$11.1 billion in tax year 2002, an increase of 21%.
- Capital gains taxes grew from \$462 million in tax year 2002 to \$785 million in tax year 2003, an increase of \$323 million, or 70%. On a fiscal year basis, FY04 capital gains taxes probably totaled about \$847 million (though no exact numbers are available), \$330 million higher than FY03. Approximately two-thirds of the growth in capital gains taxes was due to the higher tax rate on capital gains implemented during tax year 2003.
- In tax year 2002, Massachusetts had two long-term capital gains tax schedules, one for capital gains realized prior to May 1, 2002 (under which long-term gains were taxed on a sliding scale, depending on holding period) and another for gains realized on or after May 1, 2002 (under which long-term gains were taxed at 5.3%). In tax year 2003, all long-term capital gains were taxed at 5.3%. In tax year 2002, long-term capital gains realizations were taxed at an average rate of 3.7%.

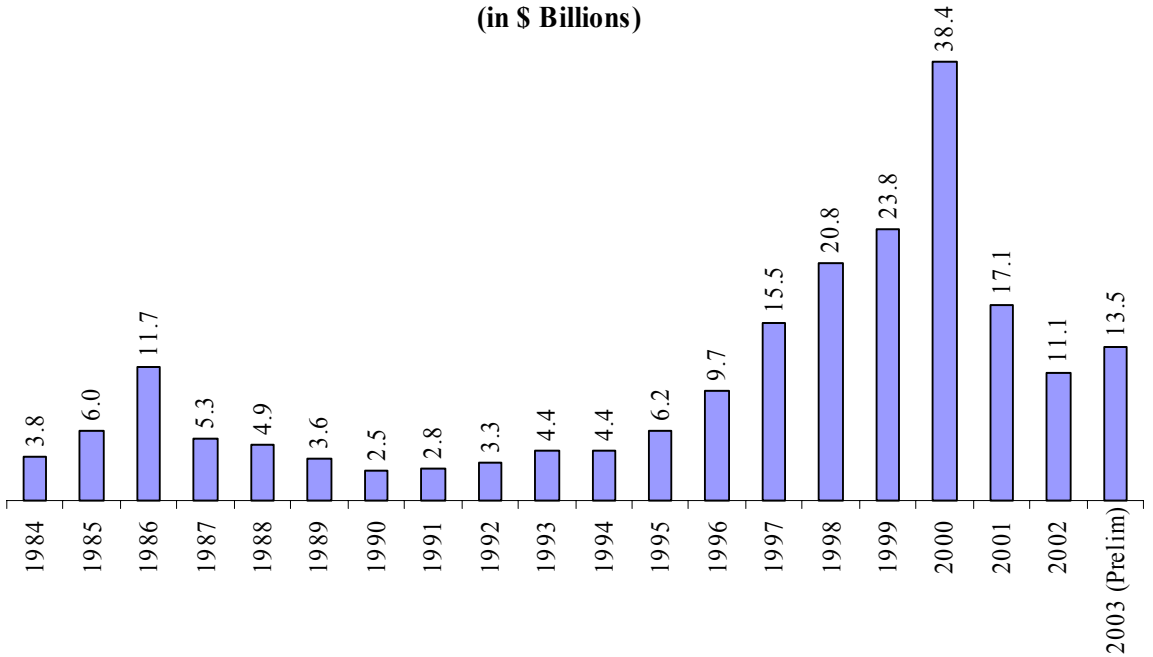
# Capital Gains Projections

---

- The October 15th estimate assumed that 2004 capital gains realizations would decline by 15% and that tax year 2005 realizations would increase by 22%.
- Economy.com (the only economic forecaster that estimates state capital gains realizations) estimates that in tax year 2004 taxable Massachusetts capital gains realizations will grow by 10% compared to 2003, tax year 2005 will grow by 13% compared to 2004. Because Economy.com is the only forecaster that estimates capital gains, their projections were used in generating all three vendors' tax revenue forecasts.
- The Economy.com capital gains forecast implies tax year 2004 capital gains taxes of \$864 million, and tax year 2005 capital gains taxes of \$976 million. On a fiscal year basis, capital gains taxes would be approximately \$886 billion in FY05 and \$1.011 billion in FY06.
- DOR's FY05 and FY06 revenue forecasts do *not* reflect the potential impact of the *Peterson* case, which resulted in the Supreme Judicial Court invalidating the capital gains tax increase enacted in mid-2002. It is expected that the SJC will decide this case sometime in calendar 2005. The issue to be decided by the Court is whether the tax increase should be effective on January 1, 2002 or January 1, 2003. If the SJC decides that the effective date is January 1, 2002, the Commonwealth stands to collect an additional \$160 million from taxpayers. If the SJC decides that the effective date is January 1, 2003, the Commonwealth will owe taxpayers approximately \$250 million in refunds.

# Capital Gains Projections

**MA Taxable Capital Gains Realizations, Tax Year Basis**  
(in \$ Billions)



**MA Capital Gains Tax Collections, Tax Year Basis**  
(in \$ Millions)

